DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0141
Gross Income Tax
For the Years 1996, 1997, and 1998

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ISSUES

I. Receipts for Graphic Design Work – Gross Income Tax.

Authority: 45 IAC 1-1-15; 45 IAC 1-1-88; 45 IAC 1-1-96; 45 IAC 1-1-121; 45 IAC 1-1-121(c).

Taxpayer maintains that the receipts it derives from its provision of graphic design work are subject to the low rate of gross income tax. In addition, taxpayer argues that the receipts derived from graphic design work provided to out-of-state customers are not subject to the gross income tax.

II. Interest Income as Intercompany Receipts – Gross Income Tax.

Authority: 45 IAC 1-1-8; 45 IAC 1-1-9; 45 IAC 1-1-10; 45 IAC 1-1-17.

Taxpayer argues that its receipt of "intercompany" interest income did not constitute the receipt of taxable "gross income."

III. Out-of-State Subsidiaries' Indiana Destination Sales – Gross Income Tax.

Authority: IC 6-2.1-1-2(a); IC 6-2.1-2-2; IC 6-2.1-2-2(a)(2); Bethlehem Steel v. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue, 598 N.E.2d 647 (Ind. Tax Ct. 1992); 45 IAC 1-1-120.

Taxpayer asserts that its out-of-state subsidiaries do not have an Indiana situs and that income derived by those subsidiaries – from sales made to Indiana customers – is not subject to the gross income tax. Even if the subsidiaries did have an Indiana business situs, the activities giving rise to that situs did not give rise to Indiana gross income tax liability.

IV. <u>Abatement of the Ten-Percent Negligence Penalty</u>.

<u>Authority</u>: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that the Department should exercise its discretion to abate the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer operates as a holding company in the business of producing plastic packaging products. Taxpayer has various in-state and out-of-state subsidiaries. Taxpayer's corporate headquarters and commercial domicile is in Indiana. The audit examined taxpayer's business records, its federal tax returns, and its state tax returns. As a result of that audit, a number of additional assessments were proposed. The taxpayer disagreed with certain of those assessments and submitted a protest to the Department of Revenue (Department). An administrative hearing was held, and this Letter of Findings resulted.

DISCUSSION

I. <u>Receipts for Graphic Design Work</u> – Gross Income Tax.

One of taxpayer's Indiana subsidiaries (Hereinafter, "taxpayer") produces customized plastic products. Taxpayer operates an arts and graphic automation department. This graphics department creates the proofs and color separations needed to produce printing plates. The printing plates are then used to print the customer's individual design work on the particular products the customer has ordered from taxpayer. The taxpayer's graphics department does not actually create the customer's design work but simply adapts the customer's pre-existing art work to conform to the surface of the intended product. For example, the department will use a computer program to adjust the customer's logo to fit on the curved surface of a plastic cup.

The audit concluded that, pursuant to 45 IAC 1-1-96, the money that taxpayer received for the performance of these design services was subject to gross income tax at the high rate.

Taxpayer disagrees arguing that, under 45 IAC 1-1-88, the provision of the design services was integral to the sale of the finished product (i.e. customer's plastic cups) and was subject to gross income tax at the low rate. According to taxpayer, the sale of the final product – including the cost of the printing plates – was a "retail sale" and the entire transaction was subject to tax at the low rate.

45 IAC 1-1-96, states as follows:

> Gross receipts from services means receipts derived from activities performed in the process of completing a service agreement or contract, and includes all amounts charged for labor and expenses forming an integral and/or required part

> of its completion. Gross income from services of any character is taxable at the higher rate. Such income includes, but is not limited to commissions, fees, receipts from service contracts or income from similar sources.

However, 45 IAC 1-1-88 establishes that certain service charges are included as part of the consideration received for "Selling at Retail" and are taxable at the lower rate. The regulation states in part:

> Gross income derived from the transfer of ownership of tangible personal property by a retail merchant through selling at retail is taxable at the lower rate. *Any receipts from services performed in connection with the sale at retail prior to the delivery of the property is also taxable at the lower rate* . . . (*Emphasis added*).

In order for the income to be taxed at the lower rate, the "income shall include all amounts representing bona fide charges added to or included in the consideration for a transaction. Such charges include charges for preparation, fabrication, alteration, modification, finishing, completion, delivery or other services performed by the retail merchant." Id. "These charges are to be stated separately or otherwise clearly determinable by the retail merchant's records and performed before the delivery of the property to the purchaser." Id.

In taxpayer's case, it was its practice to offset the income received from graphic services against related expenses in its account labeled "Bill to Customer."

The Department's regulations distinguish between services provided to the customer before delivery of the goods and services provided after the goods are delivered. The regulation specifies that income for services provided *after* delivery of the goods is to be taxed at the high rate. However, the regulation also provides that income derived from services provided *before* delivery is to be taxed at the low rate. Specifically, 45 IAC 1-1-15 states, in relevant part, as follows: "[W]hen the sales price of goods includes charges for services rendered before delivery, i.e., charges for preparation, fabrication, alteration, modification, finishing, completion, delivery charges, etc., such charges are considered a part of the sales price and are taxed at the same rate as the sale itself."

Taxpayer's customers contracted with taxpayer for the production of a customized plastic product. As part of those agreements, taxpayer's graphics department prepares the design work and printing plates necessary to imprint the customer's design on the finished goods. That design work is performed prior to the delivery of the completed goods. The service charges are "clearly determinable by the merchant's records." 45 IAC 1-1-88.

Accordingly, as set forth in 45 IAC 1-1-15 and 45 IAC 1-1-88, the income received from preparing the customer's design work and the printing plates is taxable at the low rate. The issue, initially raised by taxpayer, of whether the provision of the services, is somehow "integral" to the production of the plastic products, is irrelevant because the provision of the services is conceptually severable from the provision of the plastic products. Clearly, some of taxpayer's customers will arrange to pay for the full range of taxpayer's graphics services, while other customers will purchase only a limited range of those services. It is entirely possible that certain customers, in contracting to buy plastic products, will purchase none of the taxpayer's graphics services. In order to sustain taxpayer's basic argument, it is sufficient to find that the services – to whatever extent required – were "rendered before delivery" (45 IAC 1-1-15) and that cost of the services was related to, but separately determinable from, the charges for the plastic products themselves. *See* 45 IAC 1-1-88.

Taxpayer sets out a secondary argument related to the provision of the design services arguing that those services provided to out-of-state customers are not subject to the state's gross income tax. Taxpayer's argument is without foundation. 45 IAC 1-1-121 clearly provides that "Gross income derived from the performance of a contract or service within Indiana is subject to gross income tax." The regulation specifically addresses those instances when the Indiana taxpayer provides the service for an out-of-state customer stating that "[t]he performance of a service with or without the incidental furnishing of tangible personal property on goods belonging to others is taxable if it takes place in Indiana, regardless of whether the property is moved in interstate commerce before or after performance of the service." 45 IAC 1-1-121(c). Since the provision of taxpayer's services occurs entirely within the state, the income derived from the provision of those services is subject to the states gross income tax even if services are provided to out-of-state customers.

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Interest Income as Intercompany Receipts – Gross Income Tax.

Taxpayer borrowed money from an outside lender. When it came time to pay the money back, it charged a portion of the accrued interest due to certain of its subsidiaries. The subsidiaries then paid the interest back to the taxpayer. As a hypothetical example, taxpayer owed the outside lender $100 in interest and apportioned that $100 to three of its subsidiaries. Subsidiary one would be apportioned $25, subsidiary two $25, and subsidiary three $50. The three subsidiaries then individually paid their apportioned share of the interest back to taxpayer.

The audit determined that the interest payments taxpayer received from its subsidiaries represented gross income and assessed additional tax accordingly. The interest payments could not be eliminated as inter-company receipts since the affiliated members did not qualify to file a consolidated return.

The taxpayer has protested the assessment of this gross income tax because, according to taxpayer, its receipt of the interest did not represent "gross income." Taxpayer maintains that the interest allocation was made merely for accounting purposes and that the allocation and subsequent repayment was without economic substance. There was no debt instrument evidencing an actual obligation between the taxpayer and its subsidiaries. Rather the allocation of the interest to the subsidiaries was made to better account for the operating income and expenses of the different entities. Therefore, the inter-company interest charges were not subject to gross income tax because the charges did not constitute actual payments made to the taxpayer.

For purposes of the state's gross income tax scheme, 45 IAC 1-1-8 defines "receipts" as follows:

> "Receipts" is used synonymously with the Act *[IC 6-2.1]* and means the entire or total amount of "gross income" or "gross receipts" derived from all sources, and which are actually or constructively received by the taxpayer, credited to him, or paid to his creditors by another person. The term "receipts" is not limited to cash or checks received by or credited to a taxpayer, but also includes notes or other property of any kind, or the value received in the form of services, or receipts in any form received by or credited to him in lieu of cash.

The accompanying regulation encompasses those situations in which the taxpayer does not come into actual physical possession of gross income. 45 IAC 1-1-9 states, in relevant part that "[i]t is not necessary for gross income to actually come into a taxpayer's possession to be his gross income. Whenever gross income is 'received' in any manner other than by actual possession, gross income is considered to be 'constructively received.'" The companion regulation defines "constructive receipts" stating that "'Constructive receipts' are those items of gross income which are not actually received by the taxpayer but which are credited to him, available for his withdrawal, paid to another for his benefit, or represent income to which he is entitled." 45 IAC 1-1-10.

Under 45 IAC 1-1-17 – which defines gross income as "all income actually or constructively received" – the interest payments taxpayer received from its subsidiaries constituted "gross income." Even if the taxpayer regarded the interest allocation and subsequent repayment of that interest as a nonsubstantive apportionment of the entities' relative financial liabilities, nonetheless, the interest payments constituted the constructive receipt of the value represented by the subsidiaries' interest payments. The interest payments were "credited to him" and "represent[ed] income to which he [was] entitled." 45 IAC 1-1-10.

FINDING

Taxpayer's protest is respectfully denied.

III. Out-of-State Subsidiaries' Indiana Destinations Sales – Gross Income Tax.

Taxpayer owns a number of out-of-state subsidiaries. The out-of-state subsidiaries made sales to Indiana customers. The audit, on the ground that the out-of-state subsidiaries “channeled” their sales through taxpayer’s Indiana office, determined that the transactions were Indiana destination sales for gross income tax purposes and assessed additional taxes accordingly.

Under the provisions of IC 6-2.1-2-2, the state’s gross income tax is imposed on the receipt of “the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana.” IC 6-2.1-2-2(a)(2).

However, taxpayer indirectly cites to 45 IAC 1-1-120 for support of the proposition that the Indiana sales were not subject to gross income tax. The regulation states as follows:

> As a general rule, income derived from sales made by nonresident sellers to Indiana buyers is not subject to gross income tax unless the seller was engaged in business activity within the state and such activity was connected with or facilitated the sales. Local activity sufficient to subject the seller to taxation may result from his maintenance of a fixed business location in Indiana, or may result from the nature and extent of his business activities in the State.

Taxpayer argues that these receipts are not subject to the state’s gross income tax because the out-of-state subsidiaries do not have sufficient contacts with the state. The Indiana Tax Court has set forth a three-part test to determine whether a non-resident taxpayer has sufficient contacts with Indiana to warrant imposition of the state’s gross income tax. The taxability of the non-resident taxpayer is dependent on determining whether (1) the taxpayer’s receipts constitute “gross income,” (2) whether the “gross income” is derived from sources within Indiana,” and (3) whether the “gross income” derived from those sources within Indiana is “taxable gross income.” Bethlehem Steel v. Dept. of State Revenue, 597 N.E.2d 1327, 1330 (Ind. Tax Ct. 1992), *aff’d* 639 N.E.2d 264 (Ind. 1994); *See also* Indiana- Kentucky Elec. Corp. v. Indiana Dept. of State Revenue, 598 N.E.2d 647, 661 (Ind. Tax Ct. 1992).

The preliminary question is easily answered. Taxpayer’s out-of-state subsidiaries entered into agreements to sell goods to Indiana customers. It is not disputed that the consideration received for the shipment of the goods into Indiana constituted “gross income” for purposes of the state’s gross income tax scheme. IC 6-2.1-1-2(a) clearly provides that “[e]xcept as expressly provided in this article, ‘gross income’ means all the gross receipts a taxpayer receives . . . from the performance of contracts.” Therefore, under IC 6-2.1-1-2(a), and in the absence of any exemption to the contrary, the payments received by the out-of-state subsidiaries constituted “gross income” for purposes of determining the applicability of the state’s gross income tax.

It is the second provision of the Bethlehem Steel test which is central to taxpayer’s protest. In order for the Department to establish that the subsidiaries’ income – received for the completion of Indiana destination sales – is subject to the state’s gross income tax, the Department must establish that the taxpayer’s income is derived from a source within Indiana. Specifically, “[i]f the activities giving rise to the income sought to be taxed do not occur within Indiana, then the tax may not be levied – not because to do so is forbidden by the United States Constitution (although it may well be) – but rather because under those facts the levy is forbidden by the statute." Bethlehem Steel, 597 N.E.2d at 1330. 45 IAC 1-1-120 clearly provides that sales into Indiana by non-resident taxpayers is not subject to the gross income tax "unless the seller was engaged in business activity within the State [i.e., tax situs]." The court in Indiana-Kentucky explained stating that "the regulations teach that a nonresident is subject to taxation if the 'source' of the gross income is an Indiana *tax situs*, i.e., an Indiana *business situs* at which business activities are performed that are connected with or facilitate the transaction . . . giving rise to the gross income." Indiana-Kentucky, 598 N.E.2d at 662 (*Emphasis added*).

According to taxpayer, the facts support the proposition that its out-of-state subsidiaries have not established an Indiana tax situs. Taxpayer maintains that, the subsidiaries do not have physical locations or assets with the state; the subsidiaries do not perform direct services in Indiana; the subsidiaries do not distribute goods within the state with their own vehicles; the subsidiaries do not accept or approve contracts within the state; visits by the subsidiaries' employees to taxpayer's Indiana headquarters are de minimis; the subsidiaries do not have a commercial domicile in the state; the subsidiaries' activities are managed and directed from their respective out-of-state headquarters. In addition, taxpayer states that each of the out-of-state locations also has its own customer service representative who may be called upon to accept orders, service accounts, and answer customer questions.

The audit cited to specific instances in which the out-of-state subsidiaries had contact with the state. The general headquarters for both taxpayer and its subsidiaries is in Indiana. Most of the managerial decisions, affecting the out-of-state subsidiaries, are made in Indiana. Additional centralized Indiana activities, affecting the out-of-state subsidiaries, include: management training, research and development, payables, purchasing, payroll, software system development, and credit checks. According to the audit report, all customer orders are received at taxpayer's Indiana location by means of an 800 telephone number. All the customer orders are approved at the Indiana location. All customer complaints are handled at the Indiana location. All applications for credit are approved at the Indiana location. All requests for customer service are handled at the Indiana location.

It is apparent that the subsidiaries "[were] engaged in business activity within the state and such activity was connected with or facilitated the sales." 45 IAC 1-1-120. Not only do the out-of-state subsidiaries have substantial operational contacts with the state, it is evident that sales made by the out-of-state subsidiaries are completed within Indiana. The order for each sale is received in the state, the customer's credit is checked in this state, and the order is approved at taxpayer's Indiana location.

Therefore, given that the income at issue is derived from business activities conducted within the state, under IC 6-2.1-2-2(a)(2), the income from those business activities is subject to the state's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

IV. Abatement of the Ten-Percent Negligence Penalty.

The taxpayer argues that the ten-percent negligence penalty, associated with the imposition of the additional tax assessment, should be abated. According to taxpayer, it made every effort to comply with the state's tax laws. Given the amount of taxpayer's total sales, any error attributable to a misclassification of that income was relatively minor. Further, the gross income tax laws are subject to varying interpretations and applications.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer has presented evidence sufficient to establish to establish that its failure to pay the deficiency was due to reasonable cause and not due to willful neglect.

FINDING

Taxpayer's protest is sustained.

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